Chinese Economy_At Risk of Overheating

At Risk of Overheating

While China's urbanization drive continues to steam ahead in a rising tide of global liquidity, curbing inflation and asset bubbles are likely to remain China's main headaches, going forward.

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Remember the heady days of Japan Inc. in the late 1980s, when land in Tokyo alone was deemed to be worth more than the whole of the United States? Well, based on the average price of Beijing properties in 2010, the total land value in Beijing is estimated at $19.85 tn, way above the US GDP of $14.5 tn. Even more absurdly, the aggregate land worth of China's two leading cities, including Shanghai, is calculated to exceed the combined 2009 GDP of the world's five most advanced countries—US, Japan, Germany, France and Britain, according to an article in the *China Economic Weekly*, a magazine sponsored and managed by the People's Daily News Group.[1]

China's bank lending in 2010 was $1.2 tn, slightly lower than the all-time record of $1.4 tn in 2009. More than a quarter of bank loans poured into real estate, in search of short-term gains as the profit-margins in manufacturing, mostly resource-intensive, have been reduced to 5% or less by the demands of global 'China Prices'. According to China's National Bureau of Statistics, Chinese bank loans totaled 7.95 tn yuan ($1.212 tn) in 2010. The credit ratings agency Fitch reckons that another 3 tn yuan ($457.3 bn) worth of loans were created off-balance sheet. Much of this has gone into property speculation.

Negative deposit interest rates also spur savers to look for better short-term gains. Moderate administrative tightening measures include higher down-payment for second homes, a ban on purchase of third apartments, and a feather-light first-ever property tax in just two cities—Chongqing and Shanghai. These soft touches, wary of hurting China's rising, homeowning middle-class, fail to curb a tide of pent-up demand. The property fever is further heated by a tsunami of 'quantitative easing' liquidity finding its way from the West into emerging markets. This is driving up commodity and asset prices, adding to the inflation spiral and the desire to hold properties as a safer storage of value.

The Chinese Academy of Social Sciences estimates that despite rising income levels, 85% of households cannot afford to buy a home while based on electricity meter readings, it is estimated that there are enough empty flats for 200 million people.[2]

Handy tools

The one-year deposit rate has just been raised again by 25 basis points to 3%, effective February 9, hot on the heels of the previous increase on Christmas Day and the third time since the beginning of 2010. It is still way below the spiraling inflation rate.

To control the flood of liquidity, China raised bank reserve requirements by 50 basis points to a record

1 Cover Story dated January 26, 2011 in *China Economic Weekly* at http://www.ceweekly.cn/html/Article/20110126873189550161452.html (accessed on February 3, 2011).

2 Andy Xie, "Fear Empty Flats in China's Property Bubble", *Caixin Online*, dated August 3, 2010 at http://english.caing.com/2010-08-03/100166589.html (accessed on February 3, 2011).

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high of 19.5% on January 20, 2011, the seventh time since the beginning of last year.

During 2011, further rate hikes and increases in bank reserve requirements remain on the cards, in addition to extra administrative measures to curb property speculation.

To address inflationary pressures and asset bubbles without rocking the economic boat too much, China has tightened its monetary policy stance from ‘moderately loose’ to ‘prudent’. Bearing in mind, the need to finance ongoing infrastructural developments for China’s massive urbanization drive, the annual new lending target is likely to be set at 7 tn yuan, compared with 7.5 tn yuan in 2010, 9.6 tn yuan in 2009 and 4.9 tn yuan in 2008.

Inflation and overheating

With rising food prices, fighting inflation is right at the top of national priorities. Food price increases, however, slowed to 9.6% in December 2010, from 11.7%, suggesting that the supply crunch in fruits, vegetables and aquatic products may be moderating after the Chinese new year. Non-food prices rose only 2.1% year-over-year in December, by no means an alarming rate. Overall, inflation slightly eased to 4.6% in December, after jumping to a two-year high of 5.1% in November 2010. The average inflation in 2010 was 3.3%.

The economy expanded by 10.3% in 2010, fully leaving behind the impact of the global financial crisis. Nevertheless, in January 2011, China’s manufacturing sector Purchasing Managers Index (PMI) fell to a five-month low of 52.9%, compared with 53.9% in December. This seems to suggest continuing overcapacity, full inventory or the start of a slower growth trend.

According to Carl Weinberg, Chief Economist with High Frequency Economics, this resumed growth rate closely follows China’s historical average over the last three decades, while the eased inflation rate exactly matches China’s average over the past two decades.[3]

However, in the coming years, while China’s urbanization drive continues to steam ahead in a rising tide of global liquidity, curbing inflation and asset bubbles are likely to remain China’s main headaches.

The RMB

Increasing the value of the RMB, as US Treasury Secretary Timothy Geithner has suggested, would help ease China’s cost inflationary pressures. A higher RMB will also reduce the cost of materials and components making up a large quantity of China’s exports. However, China’s current wafer-thin manufacturing profit margins mean that any drastic appreciation of the RMB would lead to many factory closures and job losses, fanning social unrest amidst a festering sense of inequality.

Nevertheless, Geithner has recently conceded that taking account of inflation, the RMB has already been effectively appreciating by about 10% a year. In the final analysis, both to respond to international pressure and to promote domestic consumption, the RMB is likely to continue appreciating gradually over time, say by 3-5% a year. But the real ailment of asset bubbles, overheating, and currency friction lies elsewhere, in the very heart of China’s economy.

Economic rebalancing and restructuring

Premier Wen Jiabao has famously enunciated that China’s economy is ‘Unstable, Unbalanced, Uncoordinated, and Unsustainable’. Too much reliance on low-profit-margin exports is limiting Chinese people’s income, without improving the trade deficits of major importing countries. Lack of higher value-added returns continues to channel liquidity into asset inflation. Low proportion of domestic consumption prolongs the global economic imbalance where excessive Chinese saving, finances excessive American consumption. It also exposes China to external turbulence as in the case of the global financial crisis. Last but not least, a resource-intensive economy pitches China against her ecological limits and creates global energy security concerns and rivalry.

There is already a clear top-down strategy on promoting domestic consumption to redress China’s export-dependent economy. However, consumption accounts for only 36% of China’s GDP. Assuming a realistic annual rebalancing rate of 1%, it will take some 14 years before consumption reaches 50% of the GDP, let alone the level of 70% prevailing in advanced economies.

In the not too distant future, a more robust consumer-oriented economy

[3] Eric Lam, “Is China’s Scorching Economy Overheating”, *Financial Post,* January 20, 2011, at http://business.financialpost.com/2011/01/20/is-chinas-scorching-economy-overheating/ (accessed on February 4, 2011).

INTERVIEW

■ Prof. Gunther Schnabl *

"Chinese policy makers seem to be concerned about inflation and a real estate bubble as they have started to tighten monetary conditions."

The world's second largest economy is facing asset bubble, inflation and an overheating economy. How concerned are the policy makers?

Chinese policy makers seem to be concerned about inflation and a real estate bubble as they have started to tighten monetary conditions. They are gradually raising reserve requirements and introduce further controls on credit growth via the state controlled banking sector.

Generally, inflation would bring a depreciation of local currency effectively. Against this, do you think Beijing will revalue the yuan to help curb inflation?

The inflationary pressure in China originates in buoyant capital inflows, exchange rate stabilization and fast reserve accumulation. As reserve accumulation—if unsterilized— leads to monetary expansion, the outcome is inflationary pressure and bubbles in asset markets. Allowing the yuan to crawl gradually upwards will not help to curb this risk of overheating. The reason is that an upward crawling peg (as already practiced between July 2005 and July 2008) invites one-way bets on yuan appreciation, which accelerate speculative capital inflows. This effect will be very strong as long as the US Fed keeps monetary conditions extremely loose.

To cool its economy, what is it that Beijing needs to do beyond interest rates rise?

The first best solution would be to convince the US to gradually lift interest rate, but this may be impossible. The second best solution is to keep the yuan tightly pegged to the dollar to minimize speculative capital inflows. This measure could be combined with controls on capital inflows, as long as US QE2 continues.

Fears of a bubble bursting in China and bringing the rest of the stuttering world economy down with it are real, but collapse is probably not imminent. Please elucidate.

There are concerns about a bubble in the real estate market. I am also concerned about a bubble in the export sector, because since the turn of the millennium, the export sector has been subsidized via sterilization policies which keep the real yuan dollar rate depreciated. Further, subsidies for the export sector are likely to be provided via preferential low cost credit, which enables export enterprises to keep their prices in international markets low. Thus, US-Chinese trade imbalances are a problem of real and not nominal exchange rate stabilization.

Are they any impediments to the dragon continuing its very impressive growth going forward? Do you think that China's economic growth will be lower than expected?

Since the turn of the millennium low interest rate policies by the US Fed and giant Chinese US government bond purchases have inflated the US financial sector. At the same time, the low US interest rate has pushed speculative capital inflows into China. These have forced the monetary authorities into non-market-based sterilization (via reserve requirements), real exchange rate undervaluation combined with subsidized capital allocation to the export sector. The outcome has been a flourishing industrial sector at the cost of a very fragmented financial sector in China. In the US, the Chinese real exchange rate stabilization has crowded out the US industrial sector. Therefore, immense distortions have emerged on both sides of the Pacific, which already constitute or will constitute a drag on growth on for both economies. The problem of Chinese and US imbalances can be only resolved based on international policy coordination. The US agree to lift interest rates, China stops sterilization and subsidized capital allocation to the export sector. While the nominal yuan/dollar peg can remain in place (to stabilize China and East Asia), the Chinese yuan could appreciate in real terms against the dollar. This would help the US industry to compensate for the necessary consolidation in the US financial sector. In China, less industrial growth could be compensated by a more market-based development of the financial sector. Global imbalances and the risk of bursting bubbles would be resolved.

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would come about when China's urban population expands by 350 million over the next two decades. As mentioned earlier, this huge urbanization drive is happening right now.[4] Emerging from the countryside, new urbanites will eventually fill up many of the empty buildings in the current asset bubble. Let's not forget that the Shenzhen-and-Pudong urbanization miracle started with a lot of empty buildings in the beginning. This time around, the miracle is being rolled out nationwide, many times over, to China's inner provinces. In the years to come, this space is likely to remain a rich source for speculative alarm and excitement.

The coming Five Year Plan (2011-15)

Beneath the veneer of impressive economic growth, brewing discontent has been sounding a clarion call for a more balanced and sustainable society with greater economic equality, social justice, technological upgrading, innovation, ecological conservation, agricultural productivity, regional balance, and domestic consumption.

The coming 12th Five Year Plan (2011-15) to be formally unveiled in

[4] *Preparing for China's Urban Billion*, Mckinsey Global Institute, March 2008.

March is expected to see a strengthening of the social infrastructure such as education, healthcare and welfare, supported by redistributive policies including wage increases and hardship subsidies. More impetus will be given to promoting energy-saving and environmental protection, new-generation informatics, biotechnologies, and high-end manufacturing.

With more environmental awareness and the creation of more green cities, China is redoubling her efforts to turn green. She is well on track to meeting or even exceeding her target of using renewable energies for 15% of total primary energy needs by 2020. The Five Year Plan is likely to focus on new energies, new materials and new-energy (electric) cars.

All these should augur well for a model of less heated and more balanced and sustainable development, at a less heady rate of economic growth. As always, the test of this new pudding is in the eating.

An Achilles' heel

The next Five Year Plan promises to be a watershed response to China's pressing challenges of imbalance, inequality, injustice, and instability, changing tack from sheer economic to a more people-based development.

According to PEW, an independent public attitudes research center based in Washington DC, the level of the Chinese people's satisfaction with the country's direction and economy has been going up steadily over the past few decades, attaining world No.1 ranking on the eve of the Beijing Olympics.[5] For now, the overall level of satisfaction is still relatively high by international comparison, but rising discontent has become more evident with galloping prices, irregular land grabs, labor disputes, growing inequality, rampant pollution and corruption.

Although there is no organized political opposition, as China's more educated and more affluent middle-class grows to over half of the population by the latter part of the next decade, the demand for more representation, more political accountability and more civil liberties is likely to become more strident.

Enabled by New-Age social-networking technology, the Jasmine fever sweeping across the Arab world is a timely reminder that an economy, however sustainable, needs to be ultimately supported by a political system that is able to evolve effectively to respond to the changing demands of the times. It remains to be seen how, rather than forever relying on the famous Great Firewall, China can in due course harness this new connectivity of a rising and more educated middle class for the best interests of the nation.■

Reference # 01M-2011-03-02-01

5 *The Chinese Celebrate Their Roaring Economy as They Struggle with Its Costs*, 2008 PEW Global Attitudes Survey in China, July 22, 2008, PEW Research Centre, Washington DC.